

NEW RULES ON DEBT CLASSIFICATION AND LOSS RESERVE

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Following Decision No. 127/2005/QD-NHNN dated February 3, 2005 issuing the Regulations on Loans Extended by Credit Institutions to Customers, the State Bank of Vietnam (SBV) has enacted a number of legal documents aimed at improving credit quality and risk supervision and management, including Decision No. 493/2005/QD-NHNN dated April 22, 2005 issuing the Regulations on Classification of Debts and Loss Provisioning in Banking Operation of Credit Institutions. This article addresses certain significant provisions of Decision 493.

Scope of Application

According to Decision 493, all credit institutions operating in Vietnam (excluding the Bank for Social Policies) are subject to debt classification and loss provisioning requirements. Decision 493 however allows foreign bank branches licensed to operate in Vietnam, subject to SBV approval, to apply the loss provisioning policies of their parent banks.

The loss provisioning aims to compensate for credit losses of credit institutions. The loss reserve is calculated on the basis of the principal of debt and is treated as operating expenses of credit institutions.

"Debt" is broadly defined in Decision 493. "Debt" includes indebtedness or liability incurred under or in relation to loans, advances, overdrafts, financial leases, discounting or rediscounting of valuable papers, factoring (a new form of credit facility permitted in accordance with the Regulations on Factoring Transactions of Credit Institutions promulgated in conjunction with Decision No. 1096/2004/QD-NHNN dated September 6, 2004 of the SBV Governor) and "other forms of credit facility."

Classified Debt not Subject to Provisioning Requirements

Credit institutions are not required to make loss reserves with respect to (i) loans using funds entrusted by a third party who undertakes to be responsible for "settlement of risks" or (ii) loans funded by other credit institutions under syndicate arrangements for which the credit institution (presumably being the agent in this case) does not take any risk. Such loans are nevertheless subject to classification requirements set forth in Decision 493.

The expression "settlement of risks" could be well interpreted as the enforcement of collateral or the exercise of any other remedies for debt recovery. In a participation arrangement, the loan and security documents are normally signed between the lender and the borrower and the participant is not a party to such documents. As such, the participant does not have a direct recourse against the borrower (as it does not have a contractual relationship with the borrower) and it has to rely on the lender to enforce the collateral or exercise other remedies. A participant would therefore never undertake to enforce the collateral or exercise other remedies by itself. It may be the case that the lender is still required to make a loss reserve for the funds it receives under participation arrangements.

Specific Provisioning and General Provisioning

Decision 493 provides for two types of loss provisioning, specific provisions and general provisions. Provisions established to absorb unidentified losses inherent in a credit institution's loan portfolio are referred to as general provisions, and provisions established to absorb losses identified for specific loans are referred to as specific provisions. Specific provisions are already being implemented by credit

institutions and are now elaborated in Decision 493. General provisions are introduced for the first time in Decision 493 and are equal to 0.75% of the total debt classified from category 1 to category 4.

Credit institutions are generally entitled to a 5 year phase-in period to implement Decision 493. All credit institutions except for the State owned commercial banks must implement the specific provisioning requirements immediately but have 5 years after the effective date of Decision 493 (i.e., May 15, 2005) to fully achieve the required level of general provisions. With respect to the State owned commercial banks, the timeframe for establishment of both general and specific provisions, which will extend no later than 5 years after the effective date of Decision 493, will be specifically set out by the SBV and the Ministry of Finance.

Methods of Debt Classification and Loss Provisioning

In addition to the "quantitative" method already provided in its predecessors, Decision 493 for the first time allows credit institutions, if certain requirements are met including SBV approval, to apply the "qualitative" method.

"Quantitative" Method

The five-category system classifies bank loans according to their inherent risks as "pass," "special-mention," "substandard," "doubtful" and "loss", which is primarily based on the period that payments of principal and interest are overdue.

- category 1 (pass): debts that are not due and the borrower is able to pay the principal and interest of debts in full and in a timely manner;
- category 2 (special-mention): debts that are overdue less than 90 days and rescheduled debts that are not due;
- category 3 (sub-standard): debts that are overdue from 90 to 180 days and rescheduled debts that are overdue less than 90 days;
- category 4 (doubtful): debts that are overdue from 181 to 360 days and rescheduled debts that are overdue from 90 to 180 days; and
- category 5 (loss): debts that are overdue more than 360 days, rescheduled debts that are overdue more than 180 days and debts that are subject to rescheduling arrangements as directed by the Government.

However, loans may be subject to a worse rating if there are reasons to doubt the borrower's ability to continue to service such loans.

"Qualitative" Method

The "qualitative" method is based on the credit institution's internal credit ranking system and provisioning policy as approved by the SBV. Debts are also classified as "pass," "special-mention," "substandard," "doubtful" and "loss":

- category 1 (pass): debts that the borrower is able to pay the principal and interest for in a full and timely manner;
- category 2 (special-mention): debts that the borrower is able to pay the principal and interest for in full but there exists a sign of decreasing payment ability;
- category 3 (substandard): debts that the borrower is not able to pay the principal and interest for in a timely manner and some loss of principal and interest is possible;
- category 4 (doubtful): debts in relation to which the loss of principal and interest is highly probable; and
- category 5 (loss): debts that are uncollectible.

Specific Provisioning Ratios and Formula

Under either the qualitative method or the quantitative method, the ratios of specific provisions for debts of categories from 1 to 5 are 0%, 5%, 20%, 50% and 100%, respectively.

Decision 493 introduces a new formula for calculating specific provisions which is substantially different from the formula applied under the previous regulations. Under the previous regulations, loss reserve was basically calculated on the basis of the loan value. The new formula in Decision 493 is as follows:

$$R = \max \{0, (A-C)\} \times r$$

in which,

R: a specific amount for loss reserve

A: the value of the asset (i.e., the loan)

C: the value of the collateral (after being discounted by such percentage as set forth in Decision 493 for each type of collateral)

r: ratio for loss provisioning

The above formula shows that the loan loss reserve does not depend only on the value of the loan and the ratio of loss provisioning, but also on the value of the collateral. The loss reserve will be zero if the value of the collateral (C) is higher than the value of the loan (A), or in other words, credit institutions do not have to set aside a specific loss reserve for such loan.

For example, credit institution X lends customer Y 100 million dong and the value of real estate collateral for such loan is 120 million dong. Presumably this loan is classified as debt subject to the ratio of loss reserve of 20% (category 2 in Decision No. 488/2000/QD-NHNN dated November 27, 2000 (which was replaced by Decision 493) and category 3 in Decision 493). According to Decision 488, the loan loss reserve for this loan is 100 million dong x 20% = 20 million dong. Under Decision 493, the calculation is:

$$A = 100 \text{ million dong}$$

$$C = 120 \text{ million dong} \times 50\% = 60 \text{ million dong (50\% is the discount percentage applicable to collateral being immovable assets)}$$

$$r = 20\%$$

Therefore, the loan loss reserve is (100 million dong – 60 million dong) x 20% = 8 million dong. In the above example, if the collateral value is big enough so that C is higher than A (for instance, the value of the collateral is 240 million dong, C = 240 million dong x 50% = 120 million dong, and thus the difference between A and C is a minus value), then the loan loss reserve will be zero or in other words, credit institution X does not have to establish a reserve for customer Y's loan.

It should be noted that the value of the collateral set forth in the underlying security agreement will be the basis for calculating the loan loss reserve with respect to most types of collateral (generally except for gold and securities). In practice, credit institutions normally impose a nominal value of the collateral on the date of the security agreements.

Under the new formula, credit institutions may have to take seriously the evaluation of the collateral on the date of the security agreements. Nevertheless, it remains to be seen how this issue will be dealt with. For example, it is unclear how credit institutions will deal with the value of future assets if a payment default occurs before the assets come into existence. The valuation of "floating" assets, such as accounts, materials, goods in process, etc. will also be problematic.

Use of Loss Reserves

Loss reserves are used when customers are bankrupt or dissolved (for customers being organizations) or dead or missing (for customers being individuals). Loss reserves are also used when loans are classified as debts in category 5. In such cases, specific provisions and the realization proceeds of the collateral are used first to compensate for the loss. General provisions are used as the last resort.

Conclusion

Decision 493 poses a higher standard for debt control and risk management in credit institutions and the implementation of Decision 493 will help credit institutions to appraise more correctly their credit quality.

The implementation of the new provisions will require changes at credit institutions, at least in terms of capitalization for loan loss provisioning, organizational structure, personnel and data and information systems for management of overdue debts. The SBV will be required to develop its own organizational structure and personnel. In particular, supervision based on evaluation of assets quality should become a routine task of SBV inspectors. The SBV will have to build up a regime of supervision and control on the implementation of such evaluation.

Finally, since costs incurred as a result of the changes mentioned above will likely be transferred to clients, bank costs and charges probably will increase. Credit institutions may prefer secured loans to decrease the burden of loss provisioning.